BANK OF JAMAICA

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Quarterly Press Briefing
Hon. Derick Latibeaudiere, Governor, Bank of Jamaica

Good Morning Ladies and Gentlemen:

It is a pleasure to welcome you to the first quarterly briefing for 2008. As usual, I will outline the economic developments that characterized the December 2007 quarter and indicate the Bank's response to those developments as well as provide you with our outlook for the current quarter.

Overview

The December quarter presented a number of challenges to the Central Bank, that were to a large extent influenced by the threat of instability in the global financial markets and the possibility of a slow-down in world growth. In this context, we had to contend with higher levels of inflation and the instability that prevailed in the foreign exchange market prior to its recovery towards the end of the quarter.

I will start with Inflation

Headline inflation for the ***December quarter*** was 7.3 per cent. The inflation outturn for the quarter exceeded the Bank's forecast. The higher inflation in the December quarter was due mainly to supply shocks to agricultural prices. These shocks were precipitated by Hurricane Dean in August 2007 and by the extended period of rainfall in October. In addition, there were significant increases in the prices of some international commodities, particularly oil and grains. With the damage to agricultural production caused by the adverse weather conditions, prices in the category ***Vegetables & Starchy Foods*** rose by 23.6 per cent during the quarter and this was the strongest impulse to overall inflation. In fact, the movement in this category was well above the average increase of 9.1 per cent for the past 5 December quarters.

With regard to the prices of international commodities, the average price of the benchmark West Texas Intermediate crude oil rose by 20.2 per cent in the December quarter. This followed an increase of 16.2 per cent in the September quarter. These price increases led to higher prices for all energy related components in the domestic CPI. For example, we saw increases in electricity rates, in the cost of fuel and in the price of lubricants and petrol.

There were also marked increases in the international prices of raw materials used for food. The prices of corn, wheat and soybean reached historic highs as a consequence of adverse weather conditions abroad, coupled with an increasing diversion of corn to ethanol production. For example, the average price of US Hard and Soft Winter wheat rose by 24.4 per cent and 21.9 per cent, respectively, in the December quarter. This followed respective increases of 33.6 per cent and 43.0 per cent in the September quarter.

With the increase in the price of these imported commodities, the pass-through of the increased costs to fertilizers and feedstock had an adverse impact on the prices of meat, dairy products, edible oils and other food items. The movement in the prices of imported commodities would also have been exacerbated by the lagged impact of the depreciation in the exchange rate.

Headline inflation for the ***fiscal year to end-December*** was 14.0 per cent well above the 4.8 per cent for the comparable period in F/Y 2006/07. F***or the calendar year*** inflation was 16.8 per cent.

For the March 2008 quarter the Bank expects inflation to moderate to 3.5 per cent ± 0.5 of a percentage point, or about one half the rate of the price increase observed in the December quarter. The forecast for the quarter is predicated on the anticipated rebound in the supplies of short-term agricultural commodities, the impact of the Government's intervention to ease the pass-through of imported inflation to domestic prices and a general lowering of demand. In addition, we expect the exchange rate pass-through to prices to moderate.

Continued increases in international commodity prices, albeit, at a more moderate pace than in the previous quarter, could however, contribute to some cost-push inflation. In addition, the prices of some domestic staples could remain at an elevated level. Our projection for the March quarter also assumes some inflationary impulses arising from the renewal of various contracts, such as rent and insurance.

We have set out some issues in ***Boxes*** 1 and 2 that may help in your understanding of some of the factors that have affected domestic inflation in recent months.

Looking further ahead, we expect to see a steady reduction in the pace of inflation as the impact of the events of 2007 dissipates. Also, barring adverse weather conditions, domestic food supply should normalize over the next six months. In addition, we expect that a slow-down in world growth should help to restrain prices in the international commodity markets. In this context, inflationary expectations should subside and with a tight rein on domestic monetary expansion, inflation should gradually tend towards single digit by the end of FY 2008/09.

Let me now turn to the Foreign Exchange Market

There was an ***overall deceleration in the pace of depreciation*** of the Jamaica Dollar vis-à-vis the United States dollar despite the instability in the foreign exchange market during the review quarter. This was due mainly to the actions taken by the Bank.

The ***exchange rate depreciated by 0.29 per cent*** during the quarter relative to the depreciation of 2.61 per cent for the preceding quarter. However, for the calendar year the exchange rate depreciated by 4.91 per cent, relative to 3.82 per cent for 2006.

For a significant period in the quarter, the foreign exchange market experienced intense demand pressures, fuelled partly by the unexpected rate of depreciation which had been occurring since the start of the calendar year. This was exacerbated by the uncertainty surrounding the re-issue of the US dollar indexed bond, which was due to mature in November. The on-going demand pressure was also facilitated by high levels of Jamaica Dollar liquidity emanating from the net maturity of the Bank's open market instruments.

In this context, the policy actions taken by the Bank during the quarter were aimed at absorbing the excess liquidity in the system and restoring stability to the foreign exchange market. Accordingly, a two-pronged approach was pursued. The Bank offered two variable rate certificates of deposit to the market along with its usual menu of 30 - 180 day open market instruments. This was complemented by the sale of foreign exchange to the market to smooth supply conditions.

The market responded favourably to the Bank's actions with the result that there was an appreciation in the value of the domestic currency in December. The reversal in the depreciating trend in the exchange rate was also influenced by improved conditions in the market. This was evidenced by increased net private capital flows associated largely with portfolio inflows related to the purchase of Lascelles de Mercado stocks. The widening interest rate differentials caused by the softening of external interest rates also had a positive influence on the market.

Early in the New Year we again saw some resurgence in the demand pressures in the foreign exchange market. These pressures are likely to have stemmed from the concern of investors with regard to the spike in inflation in 2007 which raised inflationary expectations. The Bank has acted to bring expectations in line with its long-term objective to foster low and stable inflation. Accordingly, since January we have increased interest rates on two occasions. We also offered a variable rate certificate of deposit and reintroduced our 365-day instrument. The rate on the 365-day instrument currently stands at 15.0 per cent.

The Bank is anticipating that during this quarter, increased inflows from tourism will ease the demand pressures in the foreign exchange market. We are also expecting that with the more favourable interest rate differential, following the sharp reduction in US interest rates, private capital inflows will increase in the quarter. Indeed, we are already seeing some appreciation in the exchange rate as supplies of foreign currency to the market have increased. Nevertheless, the Bank will continue to monitor market conditions and take the necessary and appropriate action to ensure stability in the financial markets and to return underlying inflation to its long-run path.

The Real Sector

The Bank's assessment of economic activities in the December 2007 quarter indicates that real GDP growth remained weak. While there was strong growth in ***Construction & Installation***, ***Distributive Trade*** and ***Financing & Insurance***, the overall performance during the quarter would have been impacted by Hurricane Dean in August and by the prolonged period of rainfall later in the year. In this context there was a fall-out in ***Agriculture and Mining.*** An estimated decline in ***Electricity & Water*** would also have contributed to the weak performance.

For the March quarter the Bank is expecting a recovery in economic activity. The main drivers of this recovery are expected to be ***Mining, Manufacturing, Construction & Installation*** and ***Distributive Trade***. However, we expect that growth in the quarter will be tempered by continued decline in ***Agriculture***, albeit, at a slower rate than that of the two previous quarters.

Conclusion

Ladies and Gentlemen: At the international level, we are confronted with the possibility of a slow-down in world growth, led by our main trading partner, the USA, as well as volatility in international oil prices and the continued increase in the price of grains. Domestically, we are seeing an increase in the demand for foreign exchange to satisfy payments for a higher level of imports, particularly oil. These are serious challenges, but central banks are accustomed to dealing with challenges. The Bank of Jamaica therefore, will continue its efforts to maintain order in the financial markets and will remain vigilant in ensuring that underlying inflation returns to our long-term objective.